

The Emperor's New Mutual Funds

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Congress is now considering legislation that would strengthen the independence of mutual-fund boards of directors from fund managers and require cost disclosures to mutual-fund investors. Both measures would serve to increase the share of financial-market returns that fund investors earn.

Investors seem largely unaware of the substantial gap by which stock, bond and money market funds lag the returns of the markets in which they invest. While the Standard and Poor's 500 Stock Index has risen at a 12.2% average annual rate since 1984, for example, the average equity fund has grown at a 9.3% rate, only three-quarters of the stock market's return. Bond funds have earned only a slightly higher fraction of bond market returns. And yields of money-market funds are less than one-half of the current yield on short-term investments.

What accounts for these shortfalls? They are largely created by the costs incurred by mutual funds. How could it possibly be otherwise? With expert professional investors dominating the financial markets, as a group they must earn the market return before costs (a zero-sum game) and fall short of the market by the amount of the same costs they incur in the futile effort to gain an edge (a loser's game).

The costs of playing the game are surprisingly large. They include mutual-fund expense ratios, which reached an all-time high of 1.6% of equity-fund assets last year. Turnover costs, by conservative estimates, total another eight-tenths of 1%, as fund sales of portfolio securities now exceed 100% of equity-fund assets. Adding the impact of sales charges, out-of-pocket fees, and other expenses, "all-in" costs for the average equity fund come to as much as 3% per year - not surprisingly, very close to the 2.9 percentage points by which the annual returns of mutual funds lagged the stock market during 1984-2002.

Costs matter. So directing policy toward greater cost disclosure seems obvious. Two additional pieces of information, required under the pending legislation, would be invaluable: A report in fund quarterly statements showing both the annual rate and the actual dollar amount of costs that each shareholder incurs in the form of direct fund expenses; and a statement of the cost of portfolio turnover relative to the fund's assets. More information should lead to less cost. Lower costs will increase the share of market returns that mutual funds earn. But that is only part of the mutual-fund problem. Originally rooted in a focus on stewardship, the fund industry has gradually come to focus instead on salesmanship. Once dominated by highly-diversified equity funds whose returns tended to parallel the U.S. stock market itself, today eight of every 10 equity funds limit their investments to specific benchmarks like large-cap growth stocks or small-cap value stocks -- or on narrow industry groups such as technology and telecommunication.

This bewildering array of choices among nearly 5,000 equity funds has ill served investors. The returns incurred by the average equity fund investor since 1984 have averaged just 2.7% per year, a shocking shortfall to the 9.3% return earned by the average fund. The result is that the average fund investor has earned less than one-quarter of the stock market's 12.2% annual return. Compounding these annual returns over the 1984-2002 period presents a dramatic picture of the plight of the typical mutual-fund investor: As the chart nearby shows, \$1,000

invested at the outset would have produced a profit of \$7,910 in the stock market itself, a profit of \$4,420 for the average equity fund, and a profit of just \$660 for the average equity-fund investor. (See accompanying illustration -- WSJ July 8, 2003)

Officials of the fund industry trade association, the Investment Company Institute, are fond of saying that the industry has never had a major scandal. But it is surely arguable that when the average equity-fund investor earns one-twelfth of the stock market's return, that could itself be regarded as a scandal. The astonishing shortfall presents a striking illustration of the harmful impact that costs and poor selections have had on fund investors' returns. While greed and fear drive many investors to make bad choices, the fund industry created new funds that played on those emotions. As the stock-market bubble inflated, we offered investors 564 new technology, telecom, Internet and aggressive growth funds that focused on the "new economy." In the March 2000 issue of one leading financial magazine -- right at the market's peak -- the 44 funds that advertised their performance were proudly hawking an average return for the previous 12 months of +85.6%. Scandal, or not?

By our failure to act as good corporate citizens, this industry shares much of the responsibility for the great stock market bubble. There is little evidence that mutual-fund managers and security analysts were concerned about the developing flaws in corporate governance -- excessive executive compensation, managed earnings, accounting firms co-opted by managements, and directors who failed to govern in the interests of owners. Even after the fall, the silence of the funds is legendary. This industry even fought the proposal by the Securities and Exchange Commission that we disclose to our own shareholders how we vote their shares in corporate proxies.

Scandal or not, I believe that the fund industry has not adequately measured up to its statutory responsibilities of stewardship to mutual fund investors. The express language of the preamble to the Investment Company Act of 1940 calls for mutual funds to be "organized, operated (and) managed" in the interests of shareholders rather than in the interest of "directors, officers, investment advisers . . . underwriters or brokers." Yet since most new funds are organized to bring in assets and generate advisory fees, and operated at cost levels that virtually preclude market-beating returns, it is impossible to believe the standards of that preamble are being honored.

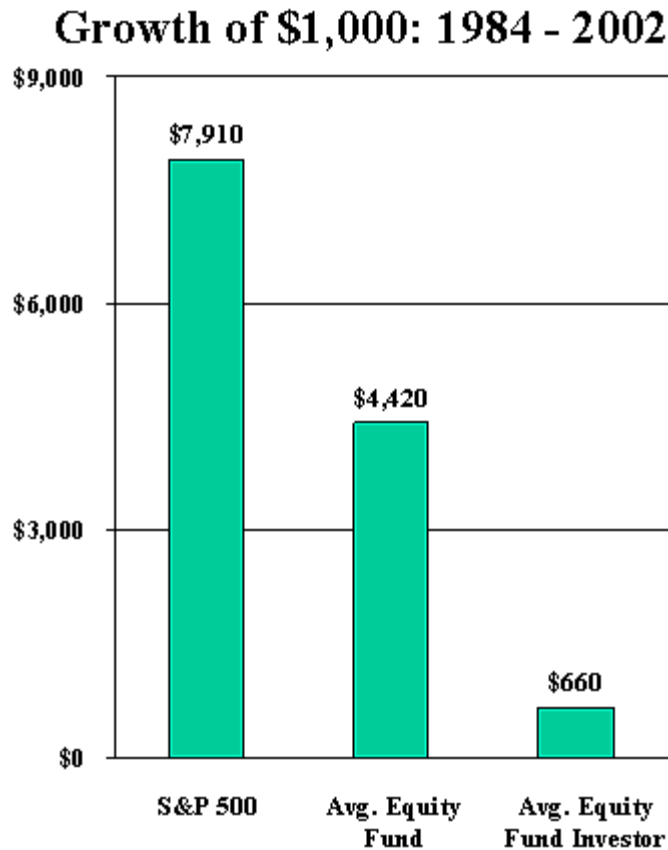
By calling for an increase in the number of independent fund directors to two-thirds of the board and an independent director as fund chairman, the proposed legislation should improve fund governance. The present situation, in which the fund adviser is typically the head of the fund's investment adviser, presents an unacceptable conflict of interest in the selection and compensation of fund management companies. Warren Buffett said it well: "Negotiating with oneself seldom produces a barroom brawl."

Together, the expense disclosure and increased director independence called for in the legislation should help limit future increases in fund expense ratios and perhaps help to mute the over-zealous marketing of funds. But I believe that the 1940 act should also be amended to call for an express standard of fiduciary duty on the part of all fund directors -- independent and affiliated alike -- to act in precisely the manner called for by the preamble: A fiduciary duty to place the interests of fund shareholders ahead of the interests of fund managers and underwriters.

The industry that I have been a part of for my entire 52-year business career, it seems to me, has a severe case of the Emperor's New Clothes syndrome. We fail to see what is obvious to all who would only open their eyes. While I'm confident that our industry's leaders are capable,

honest human beings, the powerful financial interests that they hold in the companies that manage the funds seem to have blinded them to the realities I've described.

In the long run, this industry will grow only as fund shareholders are given a fair shake, not only in costs and disclosure, but also in having truly independent directors who place their interests first. Truth told, this industry needs a change of heart, one in which our very focus moves from placing the interests of managers first to placing the interests of shareholders first. Congress can't mandate such a change of heart, we must do that in our own enlightened self-interest. Then, just as the 1940 act sought, mutual funds will once again honor their mission to serve "the national public interest and the interest of investors."



Source: Lipper, Vanguard, and Dalbar

Note: The opinions expressed in this article do not necessarily represent the views of Vanguard's present management.

http://www.vanguard.com/bogle_site/sp20030708.htm